

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:CTM:LN:TL-N-6745-00

JMMarr

date:

to: Eric Nakahara, Team Leader, LMSB:FSH 1224
Marc Partlow, Team Coordinator, LMSB:FSH 1224

from: June Y. Bass, Associate Area Counsel (LMSB)
Joyce M. Marr, Attorney

subject: Taxpayer: [REDACTED]
Timing of \$ [REDACTED] Accrual
Year: [REDACTED]

The purpose of this memorandum is to respond to your request dated November 20, 2000, for our advice as to whether the Taxpayer's obligation under an agreement was not "fixed" until [REDACTED] because the attorneys for the Taxpayer did not signify by their signatures that the agreement was "Approved As To Form And Content" by them until [REDACTED].

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

Issue

Whether \$ [REDACTED] paid by the Taxpayer, an accrual basis taxpayer, to replace [REDACTED] should not have been

deducted until [REDACTED] when the attorneys for the Taxpayer indicated by their signatures that they "Approved as to Form and Content" a "Settlement Agreement and Release of Claims" entered into by the Taxpayer and [REDACTED]?

CONCLUSION

The Taxpayer is entitled to the deduction of \$ [REDACTED] claimed for the cost of replacing [REDACTED] for the year [REDACTED], i.e., the year in which the Settlement Agreement and Release of Claims was entered into by the Taxpayer and [REDACTED]. The approval of such Agreement by the parties' respective attorneys was not a condition precedent to the Taxpayer's obligation to incur the cost of [REDACTED].

FACTS¹

On or about [REDACTED] [REDACTED] filed a Complaint for Declaratory Relief against the Taxpayer in the United States District Court for the [REDACTED] District of [REDACTED], Case No. [REDACTED], regarding the Taxpayer's right to recover under an insurance policy issued by [REDACTED] for loss and/or damage to [REDACTED] commercial buildings owned by the Taxpayer caused by the [REDACTED] in the buildings. On [REDACTED] the Taxpayer filed a counterclaim for breach of the insurance policy. The District Court entered an Order granting summary judgment in favor of [REDACTED] and denying partial summary judgment in favor of the Taxpayer. In [REDACTED] the United States Court of Appeals for the Ninth Circuit affirmed the ruling of the District Court, and subsequently denied a rehearing requested by the Taxpayer.

On or about [REDACTED] the Taxpayer filed a Complaint for Breach of Contract and Declaratory Relief against [REDACTED] in the United States District Court for the [REDACTED] District of [REDACTED], Case No. [REDACTED] with respect to its right to recover under [REDACTED] policies issued by [REDACTED] for loss and/or damage to the [REDACTED] at one of its office buildings. [REDACTED] filed a counterclaim for declaratory relief. In [REDACTED] the District Court entered orders in this action granting [REDACTED]'s Motion for Judgment on Partial Findings with respect to the Taxpayer's bad faith, punitive damage, and other claims

¹ The facts set forth in this opinion were obtained from the Examination Division, and research conducted by us on LEXIS. If the facts stated herein are incorrect or incomplete in any material respect, you should not rely on the opinions set forth in this memorandum, and should contact our office immediately.

against [REDACTED].

In a Settlement Agreement and Release of Claims (Agreement), made and entered into between the Taxpayer and [REDACTED] in [REDACTED], it was agreed that: (1) the Taxpayer waived and relinquished all appeal rights it had in connection with the foregoing civil actions; (2) [REDACTED] waived its right to recover costs and attorneys' fees incurred by it in connection with such civil actions; (3) the Taxpayer and [REDACTED] would, concurrently with the execution of the Agreement, execute and file stipulations with the United States District Court for the [REDACTED] District of [REDACTED] to dismiss with prejudice both actions; and (4) the Taxpayer and [REDACTED] released each other from all obligations related, or incidental, to the filing, prosecution, or subject matter of such actions. A copy of the Agreement is affixed hereto as Exhibit A.

Paragraph 8 of the Agreement provides, in pertinent part, as follows:

8. No Assignment; Authority.... [REDACTED]

[REDACTED]

Paragraph 9 of the Agreement states:

9. Advice of Counsel. [REDACTED]

[REDACTED]

The Agreement contains no language to the effect that it is "subject to" or "conditioned on" the approval of the parties' respective attorneys.

Paragraph 12 of the Agreement states that it is to be "interpreted, enforced and governed" in accordance with California law.

On [REDACTED], the Agreement was executed as "Agreed and Accepted" on behalf of the Taxpayer by [REDACTED] Executive Vice President, and [REDACTED], Senior Vice

President and Chief Investment Officer. On [REDACTED], it was executed as "Agreed and Accepted" on behalf of [REDACTED] by [REDACTED], Officer.

The Agreement was "Approved as to Form and Content" by [REDACTED]'s attorney on [REDACTED]. However, the Taxpayer's attorneys did not execute the Agreement to signify that "Approved [it] as to Form and Content" until [REDACTED].

The [REDACTED] on the aforesaid office building of the Taxpayer was defective in that the [REDACTED]. The Taxpayer expended approximately \$[REDACTED] to replace the [REDACTED]. Of this amount, it treated \$[REDACTED] as accrued and deductible in [REDACTED]. The Taxpayer did not treat the \$[REDACTED] as accrued and deductible earlier because it believed that the cost of replacing the [REDACTED] was not its liability. You have asked whether the \$[REDACTED] should have been treated as accrued, and deducted, in [REDACTED] when the attorneys for the Taxpayer first evidenced by their signatures that they "Approved as to Form and Content" the Agreement.²

DISCUSSION

I.R.C. § 162(a) allows as a deduction all of the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Under I.R.C. § 461, deductions are to be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

Treas. Reg. § 1.446-1(c)(1)(ii)(A) provides that under an accrual method of accounting, a liability is incurred, and taken into account, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. Treas. Reg. § 1.446-1(c)(1)(ii)(B) defines the term "liability" to include any item allowable as a deduction, cost, or expense for Federal income tax purposes.

A fundamental question involving the "fact of liability" is always whether all operative facts have occurred that establish

² The IRS Engineer assigned to the Taxpayer's case has determined that the Taxpayer is allowed to deduct, rather than capitalize, the cost of replacing the [REDACTED]. You have not requested that we opine as to whether expensing such costs is appropriate.

the liability. Such facts are those that make it clear that a taxpayer has incurred an obligation to take some action, and the obligation to take the action is fixed. If the existence of the liability is subject to a condition precedent, the obligation is not fixed until the condition has occurred or is satisfied.

The question raised by you is whether the approval of the Agreement by the attorneys for the Taxpayer was a condition precedent to the Taxpayer being liable for the cost of [REDACTED].

As indicated above, the Agreement provides that it is to be governed under the laws of the State of California.

In re Hasso, 229 Cal. App. 3d 1174, 280 Cal. Rptr. 919 (Cal. Ct. App. 1991) contains the most comprehensive recent analysis of California law regarding whether approval of the parties' respective attorneys is a condition precedent for enforcement of a settlement agreement. The Court in Hasso "reject[ed] the overly broad conclusion that parties cannot settle lawsuits without their attorneys." Jarrow Formulas, Inc. v. Nature's Way Products, Inc., 1991 U.S. App. LEXIS 20857 (9th Cir. 1991).

In Hasso, John Hasso argued that approval of the respective parties' attorneys was a condition precedent to the enforceability of a marital settlement agreement entered into with his former wife. The marital settlement agreement contained an area at the bottom for the attorneys of the respective parties to evidence by signature they "Approved as to Form." The marital settlement agreement also contained:

acknowledgments that they had retained their own counsel to advise them in connection with their rights and in the negotiation of the agreement; that each was 'fully and completely informed as to the facts relating to the subject matter of this Agreement, and as to the rights and liabilities of both parties'; that they had given 'careful and mature thought to the making of this Agreement' and had entered into it 'voluntarily, free from fraud, undue influences, coercion or duress of any kind.'

229 Cal. App. 3d at 1178-79, 280 Cal. Rptr. at 921.

Noting that courts do not construe contractual provisions so as to establish a condition precedent absent language plainly requiring such a construction, the Court concluded there was no basis for such a construction since the marital settlement

agreement contained no language to the effect that it was "subject to" or "conditioned on" the approval of the parties' respective attorneys and in fact had several paragraphs concerning the parties' intent to be bound irrespective of their attorneys' advice. 229 Cal. App. 3d at 1181, 280 Cal. Rptr. at 923.

In In re Hasso, the Court also opined that earlier case law did not support the broad holding of In re Marriage of Wickander, 187 Cal. App. 3d 1364, 232 Cal. Rptr. 621 (1964) that represented parties are absolutely forbidden from reaching settlements without the express consent of their counsel.

The Court in Wickander had viewed as dispositive the holding in Board of Commissioners v. Younger, 29 Cal. 147 (1865). However, the Court in Hasso, after analyzing the facts in Younger and the authorities relied on in that case, stated:

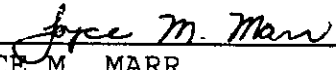
Younger, therefore, rests on the unfettered right of an attorney to control the management of the case before the court, coupled with the state Supreme Court's revulsion for a settlement procured by ex parte contact between an attorney and his opposing litigant.

Wickander's interpretation of Younger as absolutely forbidding represented parties from reaching settlements without the express consent of counsel is, therefore, incorrect. Nor do we believe that such a rule is desirable [as] a matter of public policy.

229 Cal. App. 3d at 1184, 280 Cal. Rptr. at 925.

In the instant case, the Agreement between [REDACTED] and the Taxpayer, which was executed on their behalf in [REDACTED] does not expressly state that it is subject to, or conditioned on, the approval of the parties' respective counsel. Furthermore, the Agreement indicates that the parties had the legal capacity and authority to enter into the Agreement, without the consent of any person, and one paragraph of the Agreement states that the parties consulted with their counsel in executing the Agreement. Given these facts, under California law, the execution of the Agreement by the Taxpayers' counsel to signify that they "Approved as to Form and Content" was not a condition precedent to enforcement of the Agreement. Accordingly, the Taxpayer's obligation to incur the cost of replacing the [REDACTED] was fixed as of [REDACTED], although the Taxpayer's attorneys failed to so execute the Agreement until [REDACTED].

This opinion has been coordinated with the Office of Chief Counsel. Please contact the undersigned at (949) 360-2688 if you have any questions concerning the foregoing or if you require further assistance.



JOYCE M. MARR
Attorney

Attachment: Agreement (Exhibit A)